Comments of Morgan Stanley Capital Group, Inc.
June 26 Workshop on
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Although not part of the official agenda for the June 26 workshop, there was some discussion of the topic of sellers controlling whether or not a transaction may be reported to ARB as “specified”. Morgan Stanley Capital Group, Inc. (MSCG) has also heard unofficially that other parties may submit comments on this topic. Given that the ARB rule development process does not include a “reply comment” option, MSCG therefore decided that it would be prudent to submit our views on the “seller control” topic, even though it is not 100% clear that it is appropriately part of this particular phase of rule development.

MSCG strongly believes that a seller should have no input into how a First Jurisdictional Deliverer (FJD) uses or reports a purchase from such seller. Rather, such FJD should be bound solely by rules for reporting established by ARB, and such rules should not require seller authorization, assent, permission, acknowledgement or any other form of approval of the use of the product sold. This is so for the following reasons:

I. Allowing or requiring seller input serves no environmental integrity function
II. Allowing or requiring seller input violates a basic principle of commerce, which is that a seller has no control over what a buyer does with its product, once custody transfer is complete.
III. Allowing or requiring seller input can increase costs of the GHG emissions reduction program to California consumers, with no concomitant incremental benefit.
IV. In the special case of an Asset Controlling Supplier (ACS), it is not logically possible for an ACS to sell unspecified power; that is, anything sold by an ACS should, by definition, be “specified” under ARB rules.

<u>Allowing or requiring seller input serves no environmental integrity function</u>

In order for a transaction to meet current rules for being reported as coming from a “specified” source, it must be covered by a contract explicitly designating the source, and be scheduled for delivery into California. These requirements allow verification, typically using an E-Tag, that the transaction reported did indeed originate from the specific source claimed. Adding a provision that the seller must “agree” that the transaction is for a “specified source” transaction adds nothing to the integrity of the process whereby actual emissions rates are assigned to transactions that originate from specific, agreed sources. On the contrary, such a requirement would treat otherwise identical transactions differently based solely on whether or not the seller “agrees” that the power is being sold for use as a “specified source transaction” pursuant to California ARB reporting rules. ARB should recognize that, far from adding environmental integrity to the process, invoking any sort of “seller permission” requirement effectively enlists it in deciding who should reap the commercial benefits of certain types of transactions. The parties arguing for such a provision are, in truth, seeking ARB's imprimatur in allowing them to hold counterparties hostage. For an otherwise identical transaction that meets every requirement to be reported as "specified", the seller is able to say to the FJD "the price is X, but if you want us to say that it is specified, the price is X+". ARB should not let itself be drafted into providing one party a commercial advantage over another by imposing a rule or interpretation of a rule that has no relevance to the environmental integrity of the cap-and trade program.

<u>Allowing or requiring seller input violates a basic principle of commerce, which is that a seller has no control over what a buyer does with its product, once custody transfer is complete.</u>

It is a basic principle of commerce that a seller has no further control over what a buyer does with its product once custody transfer has taken place. Allowing or requiring a seller to choose whether or not to deem a transaction to be "specified" clearly violates this principle. It is analogous to a customer who visits a car dealership and asks the price of a vehicle. Can anyone imagine the car dealer saying "well, if you agree to only drive it in the city the price is $25,000, but if you want to drive it on the freeway, the price is $30,000?" In fact, the seller actually has no reason to know what the buyer intends to do with the product at all. Indeed, in the electric industry, it is entirely possible that when a purchase transaction is struck, the buyer may not have determined what it intends to do with the power purchased, or that it may change its mind from its preliminary intent. It is also possible that the purpose may vary. Envision a unit-specific power purchase agreement for a six month period. The buyer agrees to take, say, 50 MW of power from the facility 24/7. It then decides each hour how to market the power it has bought. Some hours, the best market may be outside the CAISO. Other hours, there may be good opportunities to direct deliver the power to California and (correctly) report the transaction as coming from a specified source. In any case, the buyer owes the seller no information as to how it intends to market the power it has bought, nor should it have to ask for permission to treat the purchased power as "specified" for those hours it delivers to California. We would further note that, with the exception of an ACS (discussed further below), a seller can control how its power is used in an indirect way; it simply refuses to sell unit-specific power, instead selling "generic" power at some trading hub. There is no reason for ARB to give it extra negotiating leverage by allowing it to additionally control how any unit-specific power that it does sell is used, nor charge extra for giving its "permission".

<u>Allowing or requiring seller input can increase costs of the GHG emissions reduction program to California consumers, with no concomitant incremental benefit.</u>

As a matter or principle, ARB should take great care to avoid designing or interpreting its rules in a way that shifts commercial advantages among market participants, when such rules or interpretations are not absolutely necessary for the environmental integrity of the program. In the case of the "permission" rules under discussion here, there is another reason why ARB should not adopt such requirements.

Allowing sellers to extract increased prices that they could not otherwise obtain, due solely or even in part to the rule, would increase costs to California consumers. While the degree of pass-through may not always be 100%, it defies logic to assume that higher purchase costs on the front end do not, to at least some degree, flow though to the ultimate consumer. So, in addition to the principle of not shifting commercial advantages, ARB presumably should also strive to achieve the environmental objective at the least possible cost to consumers. Therefore, the possibility of adoption of any rule or interpretation that involves even a moderate risk of increasing consumer costs, and is not absolutely necessary for the environmental integrity of the program, should be quickly rejected.

<u>In the special case of an Asset Controlling Supplier (ACS), it is not logically possible for an ACS to sell unspecified power; that is, anything sold by an ACS should, by definition, be "specified" under ARB rules.</u>

While the discussion above makes the case against allowing suppliers in general to have veto power over whether or not power they sell can be treated as "specified", there are additional reasons why an ACS should not be allowed to deem its sales as specified or not. Indeed, in the case of an ACS, logic dictates that it is not even <u>possible</u> for it to sell "unspecified" power. The basic ACS concept is that it has agreed to certain concessions in return for certain advantages. In return for not having to schedule "specified source" transactions from each individual resource in its portfolio, it has agreed to the calculation of a weighted average emission rate which considers all of its owned resources, as well as its purchases from third parties. It may then sell power from any location as specified, and use the weighted average, portfolio-wide, ARB-approved emissions rate. Therefore, logically, it simply no longer has any "unspecified" power to sell, since everything it generates or acquires is part of its portfolio. An ACS has gained a huge degree of flexibility, in return for voluntarily constraining itself to transacting from a single portfolio. If an ACS is allowed to deem some of its transactions as "specifiable" and others not, or to treat some transactions as part of its "system power portfolio" and others not, then it has gained a huge and undue competitive advantage solely via gaming an ARB rule interpretation. Furthermore, one can even envision an argument that doing so is a form of resource shuffling, since the ACS can "cherry pick" what transactions are deemed to be part of its "portfolio" and which ones are not. Both logic and principle argue strongly for ARB to avoid having this kind of outsized impact on relative commercial advantage, and stimulating additional resource shuffling arguments. It can and should do so by stating clearly and unambiguously that <u>any</u> purchase from an ACS meets the requirements to be from a "specified" source, and can be reported as such if it meets all of the other specified source requirements.

<u>Additional Issues</u>

The sections above make the core arguments against allowing a seller to arbitrarily determine whether or not a sale can be treated as "specified" by the purchasing FJD. There are a couple of additional points worth noting. First, to be clear, MSCG is not arguing for a deal arranged without an <u>initial</u> unit-specific resource designation, to be claimable as “specified”, simply because it later gets “matched up” with a specific resource and can provide an E-Tag from a specific resource to the California border. Typical examples of this kind of transaction would be an “ICE” deal (or other exchange), a “voice broker” deal, or other kinds of transactions that are not clearly and unambiguously unit-specific from the beginning. If any party is arguing that “seller permission” is the answer to this kind of “problem”, MSCG would not disagree that the transaction type cited is inappropriate for a “specified” claim, but would strongly argue that the proposed solution is not a good fit for the problem.

Second, to the extent that ARB ultimately does decide to make the changes or clarifications in rules and/or interpretations that MSCG argues strongly against herein, such changes should be prospective only, and should be effective no sooner than 1/1/14. To do otherwise would be grossly inequitable to parties that have made commercial arrangements under good faith interpretations of the rules as written to date. Furthermore, to the extent that retroactive changes and/or clarifications create significant commercial impacts, the risk of dispute escalation, potentially even to the courts, greatly increases. Given that no environmental integrity issues are at stake, it makes the most sense to avoid such dispute resolution escalation, saving costs for both California taxpayers and regulated entities.

Thank you for considering our views. For follow-up discussion, please contact Steve Huhman at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.